Internal Revenue Service

memorandum

CC:TL-N-708-90
JCAlbro

date: DEC 22 1989

to: District Counsel, [redacted]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request for tax litigation advice dated October 27, 1989.

ISSUES

1. Whether the taxpayer is entitled to claim straight line amortization over three years for the cost of billboard sign faces.

2. Whether taxpayer's metal unipole billboard sign structures are IRC § 1245(a)(3) property eligible for investment credit pursuant to section 38 and 48.

CONCLUSIONS

1. We believe that treating sign faces as a nonsegregable portion of billboards and requiring categorization as five year ACRS property poses severe litigation hazards. We do not believe that the issue of sign faces as a separate asset from a billboard structure was considered when Rev. Proc. 83-35, 1983-1 C.B. 745 was written and that a court may find that the Rev. Proc. is unreasonable as written. We also believe that taxpayer's argument that the artwork on the sign faces has intrinsic value and is an intangible asset could be presented in a persuasive manner. We, therefore, recommend considering the intangible aspects of the sign face as separate from the physical aspects of the sign. We recommend allowing a three year amortization of the intangible (artwork) costs of sign faces. For the tangible costs (approximately 50% per sign face), we recommend a five year straight line depreciation as elected by taxpayer for the remainder of the billboard asset. We believe this is a reasonable settlement in light of the litigation hazards which exist.

2. In view of the adverse precedent in both the Tax Court and the Court of Claims, we concur in the opinion of the [redacted] Appeals office that the Service faces significant litigating hazards in [redacted] on this issue. While the sign

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structures in [redacted] are substantially similar to Structure Y in Rev. Rul. 80-151, 1980-1 C.B. 7, in view of the clear statement by the Tax Court in Standard Oil that if presented with appropriate evidence, it would follow the Court of Claims analysis in Southern Corp. and hold that sign structures embedded in concrete are tangible personal property eligible for investment credit, it is our view that the Service would not prevail in [redacted] on this issue in the Tax Court.

FACTS

1. [redacted] ([redacted]) is a subchapter S corporation which is in the business of constructing, erecting, maintaining and renting outdoor billboards. It owns approximately [redacted] billboards scattered along public highways in [redacted] and [redacted]. [redacted] leases land sites, constructs billboards and rents billboard advertising space to its customers. The signs faces consist of plywood backing on which is painted artwork with the advertising message. Some billboards are coated with Scotchlite, a reflective material. Because it is not possible to paint over Scotchlite, such sign faces are junked after three years of normal use. The artwork itself is also junked after a normal average use period of three years. The plywood is salvaged to the extent possible and reused. We understand that of the $[redacted] average cost per sign face, approximately [redacted]% or $[redacted] is attributable to artwork and [redacted]% is attributable to paint, paper and plywood.

[redacted] contends that it should be allowed to continue its practice of amortizing the costs of sign faces (artwork, plywood and other erection supplies) over their advertising contract life and/or useful life, both of which are stated to be three years. A typical contract is for [redacted] months with expected renewals to [redacted] months. The sign faces are consistently replaced after [redacted] months to maintain their quality, even if contracts are renewed for further periods. Taxpayer relies on Standard Oil Co. v. Commissioner, 77 T.C. 349 (1981) for its basic position that the sign face is a separate, identifiable structure, the useful life of which is three years. [redacted] contends that a three year life is appropriate given the nature of the asset. The remainder of the billboard consists of poles, lights and wires, and is depreciated over five years pursuant to a straight line election.

In an affidavit signed by [redacted], [redacted], the following statements are made regarding sign faces. Sign faces are ever changing assets and are often erected several months after a sign structure is erected. Pictorial artwork boards must be removed at least every three years or less and repainted in the company's plant. The Scotchlite boards have an approximate life of three years or less and must be completely replaced within three years; the plywood remnants are unusable because they will not accept paint. Sign faces are also damaged

by vandalism and weather conditions and must be replaced or repaired. Therefore, the company expects the useful life of all sign faces to be three years.

The district disallowed [redacted]'s practice of deducting the costs of sign faces over three years on a straight line basis. The district determined that the sign faces must be depreciated as five year ACRS class life property pursuant to I.R.C. § 168. Under the district's determination, [redacted] would be allowed a 15% deduction the first year, 22% the second year and 63% the third year, because the property is five year ACRS property and lasts only three years.

The Appeals Officer notes that with a turnover of one-third of the sign faces each year ([redacted] signs), there is a distorting effect on taxable income of a five year ACRS life wherein the third year bunches 63% of the cost deduction. [redacted], of course, protests such a distorting effect on its income, and cites section 446 as requiring accounting methods that clearly reflect income.

2. In [redacted], taxpayer initiated use of a new type billboard sign. These signs are metal unipole sign structures consisting of metal poles embedded in concrete foundations. [redacted] to [redacted] sign faces, scaffolding, ladders and lighting are attached to the metal pole. These new sign structures are in contrast to the bulk of taxpayer's inventory of sign structures which are wooden poles and wooden sign faces.

Taxpayer claimed five year ACRS depreciable lives on the sign structures as property described in section 1245; taxpayer therefore also claimed investment credit on the sign structures. Upon audit of taxpayer's return, Examination concluded that the sign structures were section 1250 property with a useful life of 15, 18 or 19 years, depending upon the year placed in service, and ineligible for investment credit. Examination relied on Rev. Rul. 80-151, 1980-1 C.B. 7, for its position.

Upon referral to Appeals, that office concluded that the government's potential for prevailing in the event of litigation was under 10 percent. Appeals has recommended that the government concede the issue and accept taxpayer's classification of its unipole sign structures as section 1245 property eligible for investment credit.

DISCUSSION

1. Taxpayer has used a component method of straight line depreciation and a three year useful life for its sign faces. The RAR notes that the taxpayer is not entitled to use the component method of depreciation, but must assign the costs at

issue to the same recovery class as the poles. Rev. Proc. 83-35, 1983-1 C.B. 745, identifies the asset guideline classes and depreciation periods for the class life asset depreciation range system. Billboards are identified in class 57.1 and have a guideline period of twenty years, and are, therefore, five year property under the Accelerated Cost Recovery System (ACRS). The government's position is that the taxpayer may elect to use the straight line method over a five year recovery period for billboards, but may not segregate the sign faces and amortize them over a three year useful life.

ACRS in general applies to tangible depreciable property placed in service after 1980 and before 1987. ACRS assets are grouped into recovery period classes designated by law, and the class life of an asset depends on its midpoint life under the pre-1981 Asset Depreciation Range (ADR) system. Depreciable personal property is depreciated over a 3, 5, 10 or 15 year recovery period. Prop. Treas. Reg. § 1.168-3. As an alternative to these writeoffs, taxpayers can elect to depreciate property by using the straight line method,and the applicable class life or specified extended recovery periods.

An asset is assignable to only one recovery period class under ACRS. Prop. Treas. Reg. § 1.168-3(b). See also section 168(h)(5). Three year property is section 1245 property with a present class life, as published in Rev. Proc. 83-35, of four years or less. Five year property is section 1245 property which is not three, ten or fifteen year property. Prop. Treas. Reg. § 1.168-3(c)(1)&(2). As previously noted, pursuant to Rev. Proc. 83-35, billboards are assigned to asset guideline class 57.1 with a midpoint life of 20 years; accordingly, because they have a class life of twenty years, they meet the Prop. Treas. Reg. § 1.168-3(c)(2) definition of five year property. Furthermore, the regulations state that no changes will be made to the classes or class lives which are set forth in Rev. Proc. 83-35. Prop. Treas. Reg. § 1.168-3(c)(8). Billboards also do not meet the criteria in section 168(e) for property which may be excluded upon taxpayer election from the application of the ACRS depreciation provisions.

Taxpayers may elect the straight line depreciation method and either the regular recovery period or an extended recovery period. The alternative recovery periods that can be elected with the straight line method for five year property are five, twelve or twenty-five years. Section 168(b)(3); see also Prop. Treas. Reg. § 1.168-2(c). Thus, the shortest straight line recovery period for billboards is five years. Furthermore, assuming that the sign face is a nonsegregable part of the billboard asset and that replacing the sign face after three years is a capital expenditure with respect to the improvement of the billboard, such capital expenditure is assigned to the same recovery class (five year property) as the property of which the

improvement is a part. Prop. Treas. Reg. § 1.168-2(e)(2)(iii). Although for such an expenditure, the taxpayer need not use the same recovery period and method as are used with respect to the property of which the improvement is a part, as previously discussed, within a recovery class, taxpayers may choose longer recovery periods, not shorter ones. Id.; see also Prop. Treas. Reg. § 1.168-2(c).

We understand that if this issue is litigated, taxpayer intends to argue that sign faces are intangible assets and are thus excluded from the ACRS provisions, which apply to tangible property. We are unable at this time to clarify Service position on whether sign faces are intangible assets, but we do recognize that taxpayers could present some persuasive arguments that they are intangible assets and should be subject to a three year amortization. Our litigation hazards on the intangible asset argument are based on the following considerations.

Treas. Reg. § 1.167(a)-3 provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. Rev. Proc. 89-17, IRB 89-10 (March 6, 1989) discusses the capitalization of package design costs which create intangible assets. Package design is defined as an asset created by a specific graphic arrangement or design of shapes, colors, words, pictures and lettering on a product package or the design of a container with respect to shape or function. Package design costs include materials, labor and overhead and all design exploration, study, refinement, testing and preparation of final design. IRB 89-10 at 23. See also Computing & Software Inc. v. Commissioner, 64 T.C. 223, 238 n.16 (1975) (intangible asset was credit information contained in files, not the files as such). Similarly, we believe that it is reasonable to view the artwork on a sign face as transmitting information to the public and such intangible aspect of the asset has value separate from the physical properties of the sign face.

Assets may have both tangible and intangible aspects. LTR 84-08-049 (Feb. 24, 1984) concludes that video game master tapes have both tangible and intangible characteristics. Tangible characteristics include the tape and the other physical properties on which the video game computer program is recorded. Intangible characteristics include the video game computer program and the rights to exploit it commercially. The profit derived from the sales of the games is primarily dependent upon the audience or public appeal of the intangible video game. The copyright gives the owner the right to exploit commercially the video game, and without that right the master would have only nominal value.

We believe that sign faces may also have both tangible and intangible characteristics. We believe a court could hold that an intangible asset is of use in the business for a limited time based on its physical properties or physical useful life which correspondingly would define the useful life of its intangible elements. In this case, the contract life of the sign faces is 36 months including renewals.

We note also Service position on master tape sound recordings. See [redacted], GCM 38541, I-77-80 (Oct. 24, 1980); [redacted], GCM 39111, I-127-81 (Jan. 4, 1984). Such recordings are intangible assets, and recording on tangible objects does not make an asset (a recording, an idea, artwork etc.) tangible. GCM 38541 at 4.

Lastly, it is Service position that property is intangible if its intrinsic value is attributable to an intangible element rather than to any of its specific tangible embodiments. The government has had success in arguing that computer software is an intangible asset. The courts have held that the intrinsic value of the software is attributable to an intangible element (the computer program) that is not inextricably connected to the tangible medium because the program could be downloaded electronically over transmission lines or typed in by a human programmer. Ronnen v. Commissioner, 90 T.C. 74 (1988); Bank of Vermont v. United States, 88-1 U.S.T.C. para. 9169 (D. Vt. 1988). Accordingly, we believe that taxpayer may be able to successfully argue that the intrinsic value of sign faces is not dependent entirely on the tangible billboard.

The Commissioner is generally successful in using his discretion to require a taxpayer to comply with tax accounting regulations. Yet, the Commissioner also has the discretion not to require a change in a method of accounting. There is always a hazard that a court may find that the Commissioner has abused his discretion in cases where the court finds that the taxpayer's method does clearly reflect income and in cases where the Commissioner seeks to deny the taxpayer's use of a method that is expressly sanctioned by the Code or applicable regulations. Thus, where the taxpayer shows that it has complied with all applicable requirements for adopting a method of accounting, and the use of that method is not otherwise expressly denied to the taxpayer, the Commissioner's discretion to change the taxpayer's method is extremely limited. Gertzman, Federal Tax Accounting at 2-50 to 2-52.

In [redacted], we believe that a major litigation hazard exists due to taxpayer's ability to argue that the ACRS deductions over three years distort income. Because the useful life of the sign faces is three years and because taxpayer can point to a distortion under ACRS, the intangible asset argument creates an appealing solution to a court. We believe this litigation hazard

exists even though we recognize that class lives are average lives, and a distortion will always exist when a short lived item within a class becomes useless before reaching the class life.

In summary, we believe that the taxpayer has arguments that the value of the sign face messages are intangible assets eligible for three year amortization. Combined with the argument that a distortion of income is created by treating all depreciable costs associated with billboards as one five year ACRS asset, major litigation hazards exists.

We note that the Commissioner's discretion pursuant to section 446 and the determination of whether a method of accounting clearly reflects income is, of course, relevant where the two methods of accounting at issue are both clearly sanctioned by regulations. For example, in Van Raden v. Commissioner, 71 T.C. 1083 (1979), the two methods of accounting for feed costs at issue, cash receipts or inventory, were both acceptable methods under the regulations. The Commissioner determined that the cash receipts method did not clearly reflect income. That is, regardless of the unequivocal language of the regulations allowing a farmer to use the cash method of accounting, taxpayer was still subject to the clear reflection of income test of section 446(b). The taxpayers argued that the Commissioner was precluded from applying section 446(b) because to do so conflicted with the option under the regulations for farmers to use the cash method or the inventory method of accounting. The court stated, Id. at 1102, that an unqualified and unambiguous regulation does not prohibit the Commissioner from carrying out his responsibility imposed by a discretionary code section which has such broad scope as section 446(b).

Where the question is whether one method of accounting versus another method is correct under regulations, we believe that clear reflection of income considerations may assume more importance to a court in resolving a dispute. Thus, in the instant case, amortizing a segregable portion of an asset as an intangible asset more clearly reflects income, and we believe that would act as a catalyst for a court to find that there is an intangible asset excludible from ACRS provisions.

Taxpayer's reliance on Standard Oil Co. v. Commissioner, 77 T.C. 349 (1981), does provide some analogous support for their argument that the sign faces should be considered segregable from the billboard asset which is included in guideline class 57.1 of Rev. Proc. 83-35. At issue in Standard was the eligibility of service station identification signs for the investment tax credit. The Commissioner disputed that they were eligible section 38 tangible personal property because they were inherently permanent structures. The court did segregate the signs into parts or components and noted that sign heads or images may be changed if needed. The court stated that sign

heads were separate assets from poles and foundations, and their characterization should be made separately. Id. at 405. We also note, of course, that this case presents no support for taxpayer's argument that sign faces are intangible assets. Intangible assets are not eligible for the investment tax credit, and that question was not addressed in Standard.

2. The eligibility of outdoor advertising sign structures for investment credit has been the subject of both litigation and significant administrative consideration by the Service. As indicated in the memorandum from [redacted] Appeals, the seminal case in this area is Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664 (1975), acq., 1980-2 C.B. 2; OM 18479, [redacted], I-13-76 (Mar. 10, 1976). In Whiteco, the Tax Court established five criteria for determining whether outdoor advertising billboards are tangible personal property, eligible for investment credit, or inherently permanent property, ineligible for investment credit. These five criteria were published as Service position in Rev. Rul. 80-151. See GCM 36619, [redacted], I-13-76 (Mar. 10, 1976); GCM 37723, [redacted], I-297-75 (Aug. 19, 1977).

Rev. Rul. 80-151 considers two types of advertising billboard structures. As described in Rev. Rul. 80-151, Structure X is substantially similar to the billboards considered by the Tax Court in Whiteco and is determined to be tangible personal property eligible for investment credit under the Ruling's Whiteco criteria.

Structure Y, however, is described as one illuminated 25 by 30 foot rectangular display panel that is attached to a welded steel frame. The frame is bolted to the top of a steel support column that is 5 feet in diameter. The overall height of the sign and its support structure is 74 feet. The steel support column is bolted to a steel reinforced concrete foundation fully embedded in the soil to a depth of 5 feet.

Rev. Rul. 80-151 concludes that under the ruling's Whiteco criteria, structure Y is an inherently permanent structure and not eligible for investment credit. Consequently, structure Y also is not property described in section 1245(a)(3), although this is not a holding of Rev. Rul. 80-151.

Subsequent to Whiteco, the eligibility of outdoor sign structures was also litigated in Southland Corp. v. United States, 611 F.2d 348 (Ct. Cl. 1979), and Standard Oil Co. of Indiana v. Commissioner, 77 T.C. 349 (1981). In these cases, the sign structures at issue were similar to those at issue in this case. In Southland, metal support poles were generally a steel tube 20 feet long and 8 inches in diameter; the steel tubes were set in concrete 6 feet below ground level in a concrete

foundation. The sign faces attached to the steel support tubes were either approximately 6 by 7 feet or 8 by 10 feet. In Standard Oil, the metal poles were either 15 to 17 feet high or 90 to 110 feet high; these poles were generally attached to a concrete foundation 5 to 8 feet in depth by means of anchor bolts embedded in the foundation.

In Southland, the Court of Claims concluded that "pole signs," which included the head, faces, pole, foundation, concrete and cost of installation, were tangible personal property eligible for investment credit. Similarly, in Standard Oil, the Tax Court concluded that the sign heads, light fixtures, and sign poles designed to be attached to concrete foundations were tangible personal property eligible for investment credit. The Tax Court further concluded in Standard Oil that concrete foundations were inherently permanent property ineligible for investment credit. The Tax Court also concluded that the taxpayer had not proved that a pole and the foundation in which it was embedded were not "inherently permanent property," though the court specifically stated that had the taxpayer presented "proof such as that which the Court of Claims had before it in the Southland Corp. case," 77 T.C. 409, it likely would have concluded that the pole and foundation were tangible personal property eligible for investment credit.

CONCLUSION

We recommend considering the intangible aspects of sign faces as separate from the physical aspects. Given the facts of this case, we believe that there are substantial litigation hazards and that the case should be settled. We recommend allowing a three year amortization for the intangible artwork costs of the sign faces (50%), and requiring a five year straight line election for the tangible costs, which was taxpayer's election for the remainder of the billboard costs. We note, though, that billboards belonging to other companies may have different useful lives for purposes of amortization.

We also recommend that the metal unipole sign structure issue be conceded.

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